February 5, 1996

FEB 1996
RECEIVED

Mr. David S. Guzy, Chief
Rules and Procedures Staff
Minerals Management Service
Royalty Management Program
P.O. Box 25165, MS 3101
Denver, Colorado 80225-0165

Re: Colorado Oil & Gas Association - Comments - Proposed Rulemaking - Amendments to Gas Valuation Regulations for Federal Leases, 60 Fed. Reg. 56007 et. seq.

Dear Mr. Guzy:

The Colorado Oil & Gas Association ("COGA") submits herewith its comments to the above-referenced rulemaking.

COGA is a trade association whose membership is comprised of over 200 companies of various sizes, most of which have current oil and gas operations in Colorado in such diverse disciplines as exploration and production, processing and refining, marketing, gathering and transportation, drilling and other field services, sales and supply, professional services, and consulting.

COGA appreciates the opportunity to provide these comments. COGA supports some of the proposals in this rulemaking which are potentially constructive. These proposals are noted below. However, overall the rulemaking introduces a new and onerous regime which will unduly complicate the valuation of, and accounting for, Federal royalties for our members.

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COGA disagrees with the finding of the Department under the Regulatory Flexibility Act (appearing at 60 Fed. Reg. 56015) that this rule will not have significant economic effect on a substantial number of small entities under the Act. Since the regulations will add new and very complex alternatives to existing regulations, it will increase significantly the workload of, and cost to, our members to compute and pay royalties on Federal leases under this new system. Even though our members may continue to use gross proceeds in valuing royalties regardless of whether gas is sold under an arm's-length contract is dedicated or not, there will be times when it is more profitable (for both lessor and lessee) to sell gas at index. When this occurs, the lessee becomes subject to the "second-guessing" of the safety net rule, even though the sales at index were made at arms'-length. When this occurs the producer becomes caught in the complex web of the index methodology. This interferes with the producer's right and duty under the Federal oil and gas lease to market gas in a prudent manner for the mutual benefit of the lessor and the lessee. Thus, the system discriminates against our independent members and puts them at a competitive disadvantage. No regulation should force the payment of royalties "out-of-pocket". With the addition of index pricing, the safety net regulation and the transportation allowance procedures, our members will have to employ additional personnel or contractors to perform this work in order to comply. The complexity of this new system will result in higher costs to operate Federal Leases. Higher operating costs mean eventual abandonment of producing wells. Since many wells on Federal lands do not produce substantial quantities as they may do on the Outer-Continental Shelf, the higher the cost to operate becomes, the sooner onshore wells in the Rocky Mountain area will be abandoned and royalty and tax income to governments will cease. Regulations should never be so costly that reserves can't be fully developed for that reason.

The economic impact of this regulation will be particularly significant to producers in Colorado where gas prices are extremely low. Also, with the deregulation of pipelines occurring in the state of Colorado, costs of gathering and transportation will be increasing and thus adding more to operating expense. Colorado, and the entire Rocky Mountain Region for that matter, lack sufficient market infrastructure for an index pricing scheme to operate effectively. This region is a vast area with limited pipeline access along with built-in obstacles to the efficient transportation of gas to key markets. Compared to the Gulf Coast area, production and transportation of gas in the Rockies is not as commercially mature an area. Many pipelines do not interconnect which deters the most efficient marketing and transportation of gas in this area.

COGA urges the Department to take a closer look at the impact these regulations will have on independent producers, particularly from the Rocky Mountain gas price perspective.

It is unfair to require a payor to true-up to the safety net, but not allow a credit for payments above the median price. If a safety net is used it should protect not only the Federal government, but the producer as well. The certification of the Department that a Takings Implication Assessment need not be prepared under Executive Order 12630, "Government Action and Interference with Constitutionally Protected Property Rights" is not supportable. See, 60 Fed. Reg. 56015. As discussed below, if the Department is committed to royalties based on market values, then it is unfair to base royalty values on the artificial construct of the median price analysis which is not reflective of actual prices. A Takings Implication Assessment should be prepared especially where a regulation seeks to extract a value which is contrary to Departmental pronouncements about market forces determining royalty value (see pp. 8-9 hereof).

The proposals to eliminate allowance forms, eliminate dual accounting for non-arm's-length sales of processed gas, redefining the term "gathering", permitting deduction of downstream compression expense and permitting valuation of natural gas liquids on a wellhead MMBtu basis are helpful steps in the right direction and will assist in improving royalty accounting and payment procedures.

MMS requested comment on several issues which COGA would like to address. As to comments on improving the non-arm's-length benchmarks, we believe that gross proceeds under non-arm's-length contracts should be compared to comparable arm's-length contracts in the same field or area as provided in the existing benchmarks. COGA objects to use of an affiliate's gross proceeds as the basis for royalty valuation. Piercing the corporate veil of an affiliate should occur only under clearly established legal precedent. Affiliates who are in good standing in the states of their organization and where they are doing business should not be bypassed in determining value for royalty purposes. Entities who are observing the requirements for doing business are entitled to the protection of the law and should not be ignored unless it is established that they are not being properly maintained and they are being used as an artifice or scheme to defraud.

Actually, the proposal to conduct rulemaking on "improved benchmarks" is an unfair attempt to capture downstream values on a product that has been enhanced solely by the efforts of the lessee and not the Federal government. With the regulatory prohibition against deduction of compression, gathering, dehydration and other gas conditioning costs by a Federal lessee, the Federal lessor is sharing in the enhanced value of a product which is contrary to fundamental principles of a royalty. Federal regulation does not permit the deduction of these expenses, but MMS must not lose sight of what a royalty is supposed to be. A royalty is a share of production in kind (or value) at the wellhead, See: Law of Federal Oil and Gas Leases Section 13.01[1] p. 13-3 (Rocky Mountain Mineral Law Foundation 1994). It is based upon wellhead values in the same field or area and not higher values which are created downstream of the lease and away from the wellhead. It is particularly inappropriate to seek royalty on a product which has been transformed downstream from the royalty product which existed at the time of its production at the wellhead. In many instances, particularly in the Rocky Mountain states, gas sometimes has no value at the wellhead because of the unmarketable condition of the gas at the wellhead. Sour gas, water saturated gas, impure gas and low pressure gas have no value until conditioned into a marketable product. When the lessee assumes the entire cost of this conditioning, it is unfair for the Federal lessor to seek a royalty on a product which has not been enhanced by the Federal lessee. Therefore, MMS should not promulgate regulations which seek to extend a right to a royalty beyond the point where it is appropriate, i.e., the wellhead.

The MMS also requested comments on seeking royalties on settlements resulting from contract disputes between gas producers and gas purchasers. The statement by MMS that the Committee didn't consider this issue is inaccurate. In the Committee's deliberations, abandonment of gross proceeds valuation was agreed to by MMS and the States subject to industry agreeing to the safety net median value which would be based on prices received under arm's-length contracts in the same zone and other criteria. Gas contract settlements were not included in the list of criteria. Actually the Committee specifically agreed that buyout/buydown settlements would not be used in calculating the safety net.

The MMS also requested comment on what should occur if MMS is unable to make the final two-year safety net median price determination. Actually the statement that the Committee did not address this issue is inaccurate when the record of the Committee proceedings is examined. Industry agreed to a two-year maximum period to calculate the safety net because any longer delay would militate against the certainty which the Committee was striving to achieve. The Committee received firm assurances from a senior MMS official that the necessary calculations could be made within two years. Based on these assurances, consensus was reached on the two-year limit. See: Committee Report pp. 34-35. MMS should live up to its commitment. Two years is more than adequate time for MMS to make this determination and if it fails to do so, then it should not publish a final safety net median price at all and accept the prices reported by payors subject to audit. To extend this determination beyond two years is onerous and burdensome on the independent producer. It will be difficult for payors to estimate any contingency reserve for this liability and to keep accounts open pending such resolution. Also, it will extend the time in which royalties may be audited.

Also, the safety net median price will be based on a comparison of prices received in various types of arm's-length contracts in the same field or area, Federal in-kind sales, orders to pay royalties and pending administrative and judicial action. Since the index is based upon spot prices, it is improper to use other types of contracts (non-spot) with which to value royalties paid under the index system. Arm's-length contracts outside the spot market do exist and reflect values which differ from spot prices. In fact, markets differ and comparing prices received in different markets with each other is dubious and unsupportable. Spot contracts should not be compared with any other type of contract except other spot prices in the same field or area. If gas is sold in the spot market under an arm's-length contract which complies with MMS regulations, then there should be no comparison of other prices in the field or area. Of course MMS has the statutory duty to audit royalties, but it should not reject a price paid under an arm's-length contract unless there is evidence of misconduct or a breach of the marketing covenant as presently required by current regulation. It appears to COGA that the development of the index and the safety net regulations is a thinly veiled attempt to require all arm's-length gas sales agreements to be valued as if they were non-arm's-length contracts if the producer elects to value the gas according to index.

In the preamble to the 1988 regulations, MMS made the following statement:

> ... MMS maintains that gross proceeds to which a lessee is legally entitled under arm's-length contracts are determined by market forces and thus represent the best measure of market value ...

53 Fed. Reg. 1186 (January 15, 1988).

It is clear that gross proceeds received under arm's-length contracts may no longer be acceptable if initial values are based on index and the prices received are below the safety net. We submit that MMS should return to the principles as quoted above from the 1988 regulations and not force lessees to comply with the complicated and arcane index and safety net regulations when royalties are paid on gross proceeds received under arm's-length contracts.

COGA believes that if royalties are based on gross proceeds received under any type of arm's-length contract (be it spot or otherwise), then the safety net regime is unnecessary and burdensome.

In the alternative, COGA urges MMS to invite prior public comment on the formation of index zones. There are many areas in the Rocky Mountain states which may be viable zones for index pricing which have not been identified, for example, Montana and North Dakota. Industry and the States should have an opportunity to comment on the formation of zones and also on the viability of zones for the index methodology.

The MMS also requested comment on accounting for royalties from leases, units and communitization agreements consisting of 100% Federal interests. In such situations producers should be allowed to pay on takes rather than entitlements. Since all producers have a common obligation under substantially identical leases, there is no reason to complicate royalty valuation with an entitlements approach.

The proposed regulations are particularly deficient in that they fail to address the uniqueness of high cost gas such as coalbed methane and high sulphur gas. Production of this gas is expensive and special regulations are needed to provide a fair system of valuing royalties on these types of gas. COGA believes that Federal royalties should bear an equitable share of these costs. The proposed regulations are inadequate to address these types of gas and would result in an inequitable valuation for royalty purposes.

With respect to §202.450(d)(iv)(C)(3), where the operating rights owner takes none of its entitled share of production and the production cannot be valued using an index-based method as if it had been taken, five benchmarks are proposed. COGA suggests changing benchmark number (3) - "the weighted average of the operating rights owner's gross proceeds under arm's-length contracts for that month in the field or area" - to number (1) and renumbering the remaining benchmarks accordingly. Using the current month's value in the field or area is much less complicated than having to average the last three months. Using the current month's value will lessen the administrative burden for both MMS and industry. However, the regulations do not address the situation of when there are no sales for the immediate previous three months. Thus, it is more reasonable to use only the current month's value. Requiring the compilation of additional data for the three month period is yet another example of the additional burdens this regulation will impose. In reviewing these regulations, there are numerous instances where unique data will need to be maintained in order to perform the various calculations necessary to account and pay royalties. Just the calculation of the transportation allowance (location differential?) (Section 206.454) alone requires substantial efforts which are probably beyond the capabilities of the average independent producer in Colorado. In order to do this, the independent producer will have to establish new facilities, staff and training for its personnel.

As to §202.452(b)(3), this section requires reporting NGLs in standard U.S. gallons, except for zones with an active spot market and valid published indices. This seems to be an unnecessary complication of the rule. Although NGLs are sold in gallons, reporting can and should be done on a MMBtu basis. To do so better meets MMS' and industry's objective of reporting consistency. Moreover, reporting all gas and gas products on an MMBtu basis will eliminate confusion on the part of payers as well as the increased likelihood of reporting errors.

As to §206.454(e)(7), there are questions which should be addressed regarding the convening of a technical procedural review (TPR) where the final safety net median value is disputed. How will notification to "all affected parties" be made? What happens if a company does not or cannot participate in the review and the value is later modified? Will all companies within a zone be notified of any modification to the safety net median value? These issues need to be addressed. Most importantly, we object to the TPR decision as nonappealable. Since it would have the same binding final effect as other royalty payment orders and would have a significant impact on the valuation of royalties, fairness and administrative due process requires it be subject to further review, if a lessee so elects.

With respect to §206.456, the Reg-Neg Committee employed the term "location differential" but in the proposed rule, the term "transportation allowance" is used for the same purpose without giving any reason for the change. The term "location differential" was used to distinguish between a company's actual costs for transportation and amounts that reflect a reasonable cost for transporting gas to the Index Pricing Point ("IPP"). COGA recommends, consistent with the Committee consensus, the term "location differential" be reinstated in the final rule and defined as approved by the Committee.

With respect to §206.457(c)(2)(iv)(A) and §206.459(b)(2)(iv)(A), these sections provide that for transportation systems and processing plants, respectively, purchased by the lessee or the lessee's affiliate that have a previously claimed MMS depreciation schedule, the purchaser may not treat the transportation system or processing plant as a newly installed facility for depreciation purposes. We strongly believe that if new capital is invested which would extend the economic life of producing Federal leases, then a new depreciation schedule should be approved for the new capital. The United States will benefit from new capital through the continuation of the applicable royalty income. Therefore, allowances should be permitted for the new capital until fully depreciated.

With respect to §§206.457 and 206.459, the proposed rule does not distinguish between arm's-length and non-arm's-length transactions in reporting processing allowances and it is unclear whether allowance forms are eliminated for non-arm's-length transactions. We support the Committee recommendation (Committee Report, page 73) that all transportation and processing allowance forms be eliminated for both gross proceeds and index-based payers. Therefore, in keeping with its commitment to eliminate allowance forms, MMS must eliminate <u>all</u> transportation and allowance forms for <u>both</u> arm's-length and non-arm's-length sales in the final rule.

With respect to §211.18(c)(3), COGA supports this regulation so that lessees have an exception to report and pay royalties on their entitled share of production where all operating rights owners in an agreement can agree on common reporting and payment responsibilities among themselves.

Also in the preamble to the proposed rule, at page 56015, MMS requests comments on how best to accommodate supplementary reporting. We recommend all issues arising from these regulations that may require modification to reporting requirements, including supplementary reporting as well as reporting of NGLs be referred to the Royalty Policy Committee's Subcommittee on Royalty Reporting and Production Accounting. Clearly, this Subcommittee is the most appropriate venue for determining the most efficient, streamlined, accurate reporting methodology under the amended regulations.

Sincerely,

COLORADO OIL & GAS ASSOCIATION

By______________________________
J. Greg Schnacke
Executive Vice-President